certain rates of growth in these aggregates (if it were possible) is correct during this stage of an economic recovery.

Another question likely to be on the Congressional agenda deals with the need to coordinate monetary and fiscal policies. These two policies went out of synchronization late in 1979, when the Fed moved to tighten money while the budget deficit was getting wider. The disparity became so big by midyear 1982 that a serious liquidity squeeze developed, causing the Fed to back down. Since the deficit is even larger today and is still growing, the focus in the Congress might be to ensure that monetary policy remains easy. If this is the case and the Congress succeeds in imposing its will on the Federal Reserve, then our long range prospects for inflation are not bright. There needs to be coordination between fiscal and monetary policy—but it is fiscal policy that must be changed, not monetary policy (see discussion of the budget above).

Given the levels that interest rates reached last year, the public's belief that the Fed is responsible for this, plus the fact that central banks in most other countries are under the domination of the politicians, it is going to take the best possible arguments that can be mustered by the Fed and its supporters in the financial markets to keep it independent. I can think of one right away: When central banks lost their independence in other countries, inflation worsened and business conditions deteriorated.

In the ideal world, of course, monetary and fiscal policy should be coordinated. But as readers of this Report undoubtedly have figured out by now, what is ideal in theory rarely works out in practice. As long as the real world remains imperfect, the Fed ought to remain independent, acting in the economic sphere the way the judiciary acts in the legal area—to safeguard our system. M

GOLF FANS' DREAM WEEK

WHAT:
The Manufacturers Hanover Westchester Classic

WHERE:
Westchester Country Club
Harrison, New York

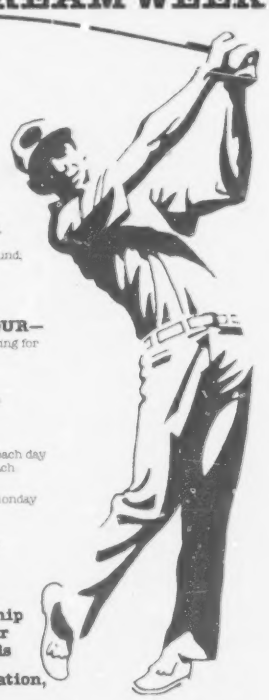
WHEN:
Monday, June 6, thru Sunday, June 12
Monday: Practice Round, **Tuesday:** Practice Round, National Long Driving Championship and Junior Golf Day, **Wednesday:** Pro-Am, **Thursday:** First Round, **Friday:** Second Round, **Saturday:** Third Round, **Sunday:** Final Round

WHO:
Many of the top pros on the PGA TOUR—
including Bob Gilder, defending champion—competing for $450,000 in prize money. Winner's purse: $81,000

HOW:
Tickets are available at the gate, or to charge on Visa or MasterCard call 212-808-8100
Sports House and Grounds: $50 for all 7 days; $5 each day for Monday and Tuesday; $10 for Wednesday; $15 each day for Thursday, Friday, Saturday and Sunday
Grounds only: $40 for all 7 days; $3 each day for Monday and Tuesday; $6 for Wednesday; $12 each day for Thursday, Friday, Saturday and Sunday
Youngsters 14 and under, accompanied by an adult: $5 (at the gate only). On Tuesday, junior golfers 18 and under are admitted free.

WHY:
The opportunity to see championship golf and support the 13 Westchester hospitals that share in the proceeds

For ticket and tournament information, call 914-967-5356



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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

JUNE 1983

Business Conditions Update

By now, it should be fairly clear that the U.S. economy has entered the expansion phase of the business cycle. It seems also safe to say that, while this recovery will not go down in history as one of the strongest, neither will it be the weakest. The upswing has enough going for it to propel business activity forward through the end of this year and well into 1984.

Evidence that the economy is on the mend is abundant. The Federal Reserve's index of industrial production, the single most accurate and important barometer of business recessions and expansions, is up about seven percent since last November. As a result, total employment in the U.S. has jumped by 900,000 since the end of last year and the jobless rate has fallen by 0.7 percentage point. With more people working, more incomes are being earned. The rise in personal incomes from March through May was the biggest three-month increase since summer, 1981. More incomes mean more spending. Automobile sales are running 50 percent above year-ago levels while new-home sales are 60 percent higher. Retail sales have jumped by nearly 6½ percent in the past three months—most of which is "real", since price inflation at the retail level remains very low.

Further gains would seem to be in store. Incomes will get another shot in the arm July 1, when personal income taxes are reduced by $35 billion. The combination of low rates of inflation, steadily falling unemployment—and a booming stock market—has evidently brightened consumer confidence. Various surveys of consumer attitudes show a distinct improvement compared with six months ago.

Notwithstanding the jump in industrial output, the level of business inventories has fallen as assembly lines were not speeded up in line with incoming orders. Over the past year business inventories have fallen nearly four percent, with the key manufacturing sector reporting a drop nearly twice as much. As a consequence, inventory-sales ratios have descended from their highs of 1982. In many lines of business, inventories are the thinnest they have been in several years.

These factors alone would seem to suggest that the recovery is building upon itself. The combination of rising sales and orders and falling inventories represents a powerful temptation to restock. Some will rebuild, but many other industries will simply aim to halt the runoff in inventories, neither liquidating or accumulating. This would be quite a change from the normal inventory cycle at this point in a business expansion.

A Modest Inventory Buildup . . .

There are several good reasons why inventories will not be rebuilt as quickly as they were in the past. For one thing, interest rates remain historically high, both in nominal or quoted terms, as well as after factoring out inflation. Because this is a relatively new phenomenon, high real interest rates have become a deterrent to spending and borrowing and an inducement to saving and investment.

Another reason for going slow regarding inventory investment seems to be the generous degree of capacity available both here and abroad. Low rates of capacity utilization clearly indicate that suppliers have the ability to provide needed goods with a minimum of waiting. This goes for the United States, as well as for our major trading partners, whose economies, as you know, have been depressed as well. The continued strong dollar makes imported merchandise even more tempting as a source of refilling pipelines.

NO REPORTS IN SUMMER

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The inventory cycle will also be affected by recent inflation trends. In the past, with inflation escalating through each business cycle, memories of rapidly rising prices were still clear and businessmen sought to replenish their stocks sooner, rather than later, in order to avoid paying higher prices. This time, however, the attitude is just the opposite—not surprising, in view of the degree to which the rate of inflation has moderated.

There are other deterrents to inventory building, too. Weak balance sheets are causing many companies to try to reduce their level of indebtedness as their sales and order prospects improve. Rather than building inventories, they are utilizing improved cash flow to pay off debt. Those companies that have access to the bond markets are borrowing long-term money and using it to pay off short-term debt. The stock market is being utilized in a similar fashion. Even if the rate of bond and stock financing in evidence during the first four months of this year continues through yearend, corporate balance sheets (the ratio of short-term to total liabilities) in the aggregate will do no more than return to their condition at the end of 1980.

. . . Plus Cautious Money Management . . .

Finally, there is a degree of caution that can only come as a legacy from a recession that by many accounts was the worst in the postwar era and a recovery preceding it that was the shortest in 60 years. Not only are businessmen shell-shocked from the recession as well as from the apparent difficulty they are experiencing in raising prices some six months into recovery, but they are concerned about the future, especially when they hear more and more economists talk about the concerns they have over the economic outlook.

Not that anyone thinks the recovery will not make it through year-end 1983. The consensus of economic forecasters is firmly united on this point. Indeed, one would have to look very hard to find a forecaster anticipating a downturn in 1984. Most economists are leaning toward even faster rates of growth in 1984 than in 1983. It's just that, in analyzing the outlook, so many economists tend to couch the good news with caution.

To be sure, there is no shortage of things to be concerned about. Looking at the near term, the first item that comes to mind is excess money growth and financial market fears of higher interest rates as a by-product. Since the beginning of the year, the widely-watched money supply M1 has jumped by nearly $32 billion, when adjusted for seasonal variation. This has placed its year-to-date growth about $14 billion above the Federal Reserve's upper target boundary, raising the specter of higher interest rates because of either a tightening of the money and credit reins some time soon, or because of the flare-up in inflation that would result if this growth were left unchecked.

However, while the seasonally adjusted money numbers have been soaring, the actual money supply has been declining. Since the turn of the year, the unadjusted M1 has actually fallen by over $6 billion. The money supply usually falls during the first half of the year, but apparently the decline in first-half 1983 was not very large. It is difficult to say what the trend ought to be for this variable in view of the changes it has undergone in recent years, what with the development of new savings and checking accounts, money definitions and the like.

Needless to say, the markets are the ones that matter and if they are keeping interest rates high because of concern over money growth, then whether the actual money supply is rising rapidly or not becomes almost irrelevant. As long as interest rates remain where they are, it is possible that such credit-sensitive sectors of the economy as autos and housing will not be able to improve their performance much more. And both industries' sales are not much higher than levels first reached at the end of 1982.

If this were not enough, economists are concerned over the export sector. Not only are we exporting less and importing more, but barriers to the free flow of world trade appear to be popping up as fast as weeds in a summer garden. As I pointed out last month, net exports exerted a disproportionate effect on the economy between summer 1981 and spring 1983, accounting for nearly 70 percent of the drop in the real GNP. Continuing on the international scene, there are worries about the ability of many developing countries to continue to absorb U.S. exports in light of their well-publicized liquidity difficulties, not to mention service their external debt, as well as whether oil prices will take another giant step downward thereby exacerbating other countries' debt burdens.

June, 1983
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual						Projected >					
	1982				YEAR 1982		1983				YEAR 1983	
	I	II	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH
Gross National Product	2995.5	3045.2	3088.2	3108.2	**3059.3**	**4.1**	3170.9	3261.0	3330.6	3407.4	**3292.5**	**7.6**
GNP: $72	1470.7	1478.4	1481.1	1477.2	**1476.8**	**−1.7**	1486.2	1511.6	1530.6	1548.3	**1519.2**	**2.9**
% Change, Annual Rates	−5.1	2.1	0.7	−1.0	**−1.7**		2.5	7.0	5.1	4.7	**2.9**	
Consumption	1919.4	1947.8	1986.3	2030.8	**1971.1**	**6.9**	2054.2	2100.8	2145.3	2192.6	**2123.2**	**7.7**
Durables	237.9	240.7	240.3	251.8	**242.7**	**3.5**	257.3	267.3	277.2	289.5	**272.8**	**12.4**
Non-Durables	749.1	755.0	768.4	775.7	**762.1**	**3.7**	776.8	788.7	802.5	814.2	**795.6**	**4.4**
Services	932.4	952.1	977.6	1003.3	**966.3**	**10.6**	1020.0	1044.8	1065.7	1088.9	**1054.9**	**9.2**
Investment	414.8	431.5	443.3	391.5	**420.3**	**−10.9**	421.3	468.2	482.2	500.9	**468.1**	**11.4**
Non-Residential	357.0	352.2	344.2	338.4	**348.0**	**0.5**	338.1	339.3	342.5	349.4	**342.3**	**−1.6**
Producers Durable Equipment	215.6	208.6	203.0	198.8	**206.5**	**−4.6**	200.7	203.4	206.9	211.2	**205.5**	**−0.5**
Structures	141.4	143.6	141.3	139.6	**141.5**	**9.0**	137.4	135.8	135.6	138.2	**136.8**	**−3.3**
Residential	93.4	95.5	94.3	101.4	**96.2**	**−8.4**	120.5	131.4	140.5	141.9	**133.6**	**39.0**
Inventory Changes	−35.6	−16.2	4.7	−48.3	**−23.9**		−37.3	−2.5	−0.8	9.6	**−7.8**	
Net Exports	31.3	34.9	6.9	9.1	**20.6**		19.0	12.8	4.2	−0.4	**8.9**	
Government Purchases	630.1	630.9	651.7	676.8	**647.4**	**8.4**	676.4	679.2	698.9	714.3	**692.2**	**6.9**
Federal Defense	166.2	176.2	182.7	189.3	**178.6**	**16.2**	192.9	201.4	209.3	215.7	**204.8**	**14.7**
Federal Civilian	83.5	68.2	76.3	89.4	**79.4**	**5.5**	81.1	71.2	77.2	81.2	**77.7**	**−2.1**
State & Local	380.4	386.6	392.7	398.0	**389.4**	**5.8**	402.5	406.6	412.4	417.4	**409.7**	**5.2**
Final Sales: $72	1486.1	1482.7	1477.8	1497.5	**1486.0**	**−0.5**	1502.3	1512.8	1531.0	1544.3	**1522.6**	**2.5**
% Change, Annual Rates	0.2	−0.9	−1.3	5.4	**−0.5**		1.3	2.8	4.9	3.5	**2.5**	
GNP Price Index (1972 = 100)	203.7	206.0	208.5	210.4	**207.1**	**5.9**	213.4	215.7	217.6	220.1	**216.7**	**4.6**
% Change, Annual Rates	4.3	4.6	5.0	3.7	**5.9**		5.7	4.5	3.5	4.6	**4.6**	
PCE Deflator (1972 = 100)	202.2	204.0	207.7	210.0	**206.0**	**5.9**	211.1	213.6	215.8	218.1	**214.6**	**4.2**
% Change, Annual Rates	4.9	3.6	7.5	4.5	**5.9**		2.1	4.8	4.2	4.3	**4.2**	
Consumer Price Index (1967 = 100)	283.3	287.0	292.4	293.8	**289.1**	**6.2**	293.5	296.7	300.2	303.7	**298.5**	**3.3**
% Change, Annual Rates	3.0	5.3	7.8	2.0	**6.2**		−0.4	4.4	4.8	4.8	**3.3**	
Total Personal Income	2510.4	2552.5	2592.4	2624.0	**2569.8**	**6.4**	2648.3	2706.3	2760.2	2821.6	**2734.1**	**6.4**
Disposable Personal Income	2117.1	2151.5	2198.1	2224.3	**2172.8**	**7.1**	2247.2	2302.0	2365.3	2417.6	**2333.0**	**7.4**
Savings Rate	6.6	6.7	6.9	6.0	**6.5**		5.9	6.0	6.6	6.6	**6.3**	
Employment Rate	56.6	56.4	56.2	55.8	**56.2**		55.6	56.1	56.5	56.7	**56.2**	
Unemployment Rate	8.8	9.4	10.0	10.7	**9.7**		10.4	10.0	9.7	9.5	**9.9**	
Indus. Production (1967 = 100)	141.8	139.4	138.2	135.3	**138.6**	**−8.1**	138.4	143.8	146.5	148.9	**144.4**	**4.1**
Housing Starts (000)	902.7	949.7	1121.7	1261.0	**1058.8**	**−3.7**	1701.7	1560.7	1605.1	1628.0	**1623.9**	**53.4**
Domestic Auto Sales (000)	5733.3	5466.7	5504.3	6133.3	**5709.4**	**−8.2**	6000.0	6511.1	6853.3	7382.0	**6686.6**	**17.1**
Corporate Pre-Tax Profits	171.6	171.7	180.3	175.9	**174.9**	**−24.6**	178.3	196.3	206.7	215.1	**199.1**	**13.9**
− Taxes	56.7	55.3	60.9	58.0	**57.7**		65.7	69.6	70.3	73.0	**69.6**	
Net Profits	115.0	116.3	119.4	117.9	**117.2**	**−22.4**	112.5	126.7	136.5	142.2	**129.5**	**10.5**
− Dividend Payments	68.8	69.3	70.5	72.4	**70.3**	**7.9**	73.5	73.8	75.6	77.6	**75.1**	**7.0**
Undistributed Profits	46.1	47.0	48.8	45.5	**46.8**	**−45.4**	39.0	52.9	60.8	64.6	**54.3**	**15.9**
+ Depreciation	208.8	216.5	223.7	231.9	**220.2**		239.9	248.1	256.2	264.0	**252.1**	
− Inventory Profits	4.4	9.4	10.3	12.6	**9.2**		0.7	1.7	5.2	7.0	**3.6**	
Net Cash Flow	250.5	254.1	262.2	264.8	**257.9**	**2.9**	278.2	299.3	311.9	321.5	**302.7**	**17.4**

Sometime in 1984, we will have to face the prospect for a clash between Washington's financial needs and those of the private sector. As long as the budget deficit remains large, Washington will be a major factor in the credit markets. This year, Washington's financing needs can be met in the context of stable to declining interest rates because of the accommodative posture undertaken by the Federal Reserve as well as because of the reduced short-term credit needs by the private sector.

But this combination will not last indefinitely. For one thing, the Fed cannot remain accommodative for too long—regardless of the degree to which the seasonal adjustment factors may be distorting money growth. As for the private sector, there will come a point in 1984 when it will make less and less financial sense for businessmen to borrow long-term to finance short-term needs—especially if long-term interest rates remain well above rates available on short-term loans. Thus it could very well be that the demand for short-term funds by the private sector will increase at the very moment that the Federal Reserve becomes less generous. With Washington continuing to raise huge sums of funds in the money markets to finance its mega-deficits, this would seem to be a recipe for sharply rising interest rates. And high interest rates, as we have clearly seen, are, in turn, a recipe for recession.

. . . Might Produce a Healthy Recovery

One cannot blame businessmen for being cautious over the economic outlook. But this very caution may keep the economy expanding longer than some expect. For it will keep a lid on wages and prices and turn businessmen (and consumers) into better managers. This is bound to improve efficiency, making us more competitive with products produced abroad. At the same time, better cash management might delay the clash between the private sector and the public sector, allowing the Federal Reserve to slow the growth rate of money without precipitating a hike in interest rates. Needless to say, the longer the economy recovers, the more tax revenues will be generated and the less Washington's budget deficit will be. Lower unemployment and a slow rate of inflation will help the spending side of the budget.

In other words—fears of a weak and short-lived recovery could well contribute to turning this expansion into one of the healthiest ones in postwar economic history. We just might be on the track to sustained economic growth with moderate rates of inflation. H

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